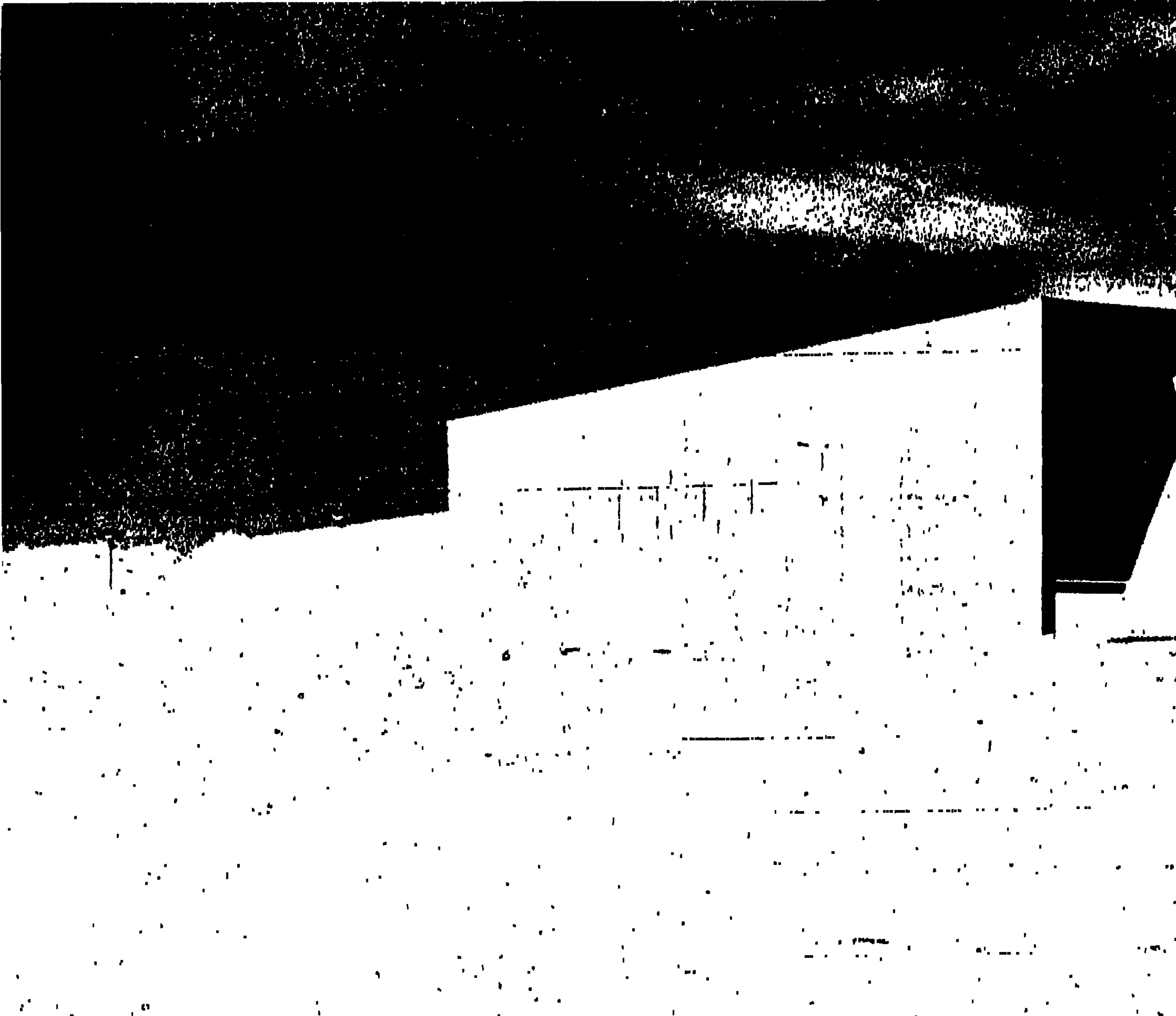
Food Fair, Inc.
1977 annual report



OUR BUSINESS

Food Fair, Inc. is a diversified retail chain with 490 supermarkets and 79 discount department stores at fiscal year end serving consumers in 14 eastern seaboard states from New Hampshire to Florida.

The Company also manufactures and processes foods for sale in its stores as well as to others, and has several non-food related operations.

In addition, the Company owns 40% of the common stock and all of the preferred stock of Amterre Development Inc., one of the country's largest publicly owned shopping center and real estate development firms.

FORM 10-K

A copy of Form 10-K for the fiscal year ended July 30, 1977, which has been filed with the Securities and Exchange Commission, is available to shareholders at no charge upon written request to Office of the Corporate Secretary, Food Fair, Inc., 3175 J.F. Kennedy Boulevard, Philadelphia, PA 19101

COMMON STOCK TRADED

New York Stock Exchange
PBW Stock Exchange

COVER

From Frost Valley to Fyne Taste, from Party Platters to Hot Foods-To-Go, the cover collage depicts a number of the merchandising initiatives taken by the Company during the year.

Jack Friedland, center, president and chief executive officer, with top officials of the company's retail divisions, Gerald Nathanson, left, president of J. M. Fields, and Frank N. James, president of Pantry Pride, at Fields-Pantry Pride center in Cherry Hill, N. J.

COMPUTER-ASSISTED CHECKOUT is being tested in the Moorestown, N J , Pantry Pride Items are "scanned" by laser beam and description and prices automatically flashed to consumer and recorded on register receipt. System eliminates key punching and permits items to be scanned and bagged in one operation.

Letter to Shareholders

Fiscal 1977 income from continuing operations was $3.2 million, or 43 cents a share, compared with $6.6 million, or 88 cents a share, a year ago. After a special credit of $4.2 million, or 57 cents a share, from changes in accounting methods, net income came to $7.4 million, or $1.00 a share. This compares with $3.8 million, or 51 cents a share, a year ago, after a $2.7 million loss from discontinued operations.

In the fourth quarter, an operating loss of $2.9 million, or 40 cents a share, was incurred, compared with an operating profit of $1.5 million, or 20 cents a share, a year ago. With the accounting changes, fourth quarter net income of $1.2 million, or 17 cents a share, was recorded, compared with the $1.5 million, or 20 cents a share, a year ago.

Fiscal year performance, particularly in the fourth quarter, was adversely affected by the lingering effects of a meatcutters' strike which closed 93 of our Philadelphia-area supermarkets for three weeks in the third quarter, and a substantially widened operating loss incurred by our department store division. This was largely as the result of markdowns required to dispose of inventory not compatible with the merchandising policies of the new operating management.

Other factors which retarded earnings throughout the fiscal year included a 14-week strike which shut down our meat-packing plant in Denver, Colorado, higher wage costs not fully reflected in retail prices, and increased promotional costs required to stimulate food sales in a heightened competitive climate.

The strikes in Philadelphia and Denver also contributed to a decline in sales to $2.4 billion from $2.5 billion a year ago.

At J. M. Fields, a number of major steps were taken to restore the discount department store division to profitability. Gerald Nathanson, president of Jefferson Stores, a successful discount department store chain in Florida, joined the Company in January as a corporate vice president and president and chief executive officer of J. M. Fields. Mr. Nathanson has totally restructured the top management team and instituted major changes in basic operating and merchandising policies in preparation for launching a major sales-building campaign with the start of the 1978 fiscal year. In that connection, it was decided to dispose of dated inventory and start the fiscal year with merchandise conforming to the new merchandising policies. The markdowns required to achieve this goal were a major factor in J. M. Fields' higher operating loss in fiscal 1977.

The new merchandising and sales programs initiated with the 1978 fiscal year have produced excellent sales increases to date.

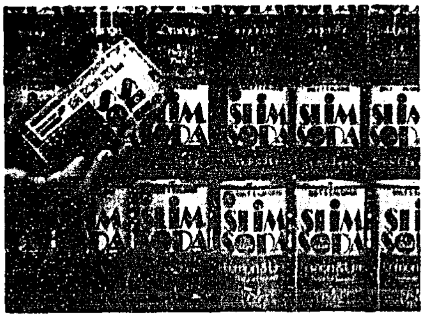
Despite the circumstances which impeded earnings' growth in fiscal 1977, several important actions were taken in implementing a five-year growth program I outlined to shareholders in last year's annual report.

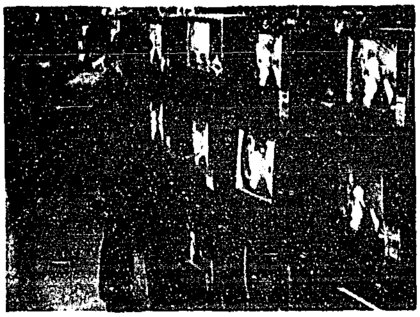
A major tenet of that program is the strengthening of our share of market in those geographic areas of our major concentration. Two important steps were taken in this respect: the acquisition of 17 Penn Fruit and 43 Hills supermarkets in our Philadelphia and metropolitan New York areas, respectively. We believe that these stores, which complement our Pantry Pride and Food Fair supermarkets already serving those areas, will enable us to compete more efficiently and expand our sales base at a minimal increase in operating costs.

In addition to the acquisition of these 60 stores, we opened five new Pantry Pride supermarkets. We also remodeled 23 existing units including five which were enlarged and 13 in south Florida which were converted to discounting operations under the Pantry Pride name. This is in line with our previously-announced program of refurbishing our retail outlets on a regular basis to maintain their competitive strength. Eighteen food units and three J. M. Fields stores were closed.

In planning for achievement of our longer-term goals, we completed with a group of 10 banks a $50 million revolving credit loan agreement which runs until March 31, 1979, with an extension for another year under certain conditions. The initial borrowing of $37 million was used to retire short-term debt. Future advances will be used for general working capital.

SLIM Soda (photo, upper right) is new private-label line of sugar-free carbonated soft drinks, produced at our own beverage plant.





	52 Weeks Ended	
	July 30, 1977	July 31, 1976
Sales	$2,436,702,000	$2,507,040,000
Income from Continuing Operations	$ 3,246,000	$ 6,576,000
Loss from Discontinued Operations*	—	$ 2,748,000
Cumulative Effect of Changes in Accounting Methods**	$ 4,175,000	—
Net Income	$ 7,421,000	$ 3,828,000
Cash Dividends	$ 1,548,000	$ 1,562,000
Current Assets	$ 308,583,000	$ 287,960,000
Current Liabilities	$ 180,459,000	$ 186,390,000
Shareholders' Equity	$ 140,456,000	$ 134,766,000

*Equity in loss of discontinued operations of Amterre Development Inc.
**See Note 2 to Financial Statements

In August of this year, Amterre Development Inc, a real estate and shopping center development firm in which we have a 40% interest, announced it had entered into negotiations to sell its shopping centers, undeveloped land and certain other assets to a group of private investors. Significant terms of the transaction remain to be resolved. The sale, which is still subject to the execution of a definitive agreement as well as the approval of Amterre's board of directors and shareholders, is expected to yield between $3 and $3.50 a common share, before taxes. Your Company holds 3.3 million of Amterre's 8.3 million shares of common stock outstanding.

Looking to fiscal 1978, we plan a continuation of our selective new-store opening program in our major marketing areas along the eastern seaboard and the refurbishing of existing retail stores with potential for growth.

As we establish long-range sales and profit goals, so must we plan for the development of a well-trained management team to guide the destinies of the enterprise in the years ahead. Within our supermarket division, we established last year a department of human resources which concentrates its efforts on professional development of qualified men and women for middle- and upper-level management positions.

At the top management level, Frank N. James was appointed president of our Pantry Pride Supermarket Division and Marvin Lerner, executive vice president. Mr. James and Mr. Nathanson, president of J. M. Fields, were also elected directors of the Company and members of the executive committee.

A group of executives who provide valuable counsel in administrative and support services including distribution, industrial relations, manufacturing, real estate, construction, long-range planning and finance comprise the corporate Staff Committee. This committee develops programs to meet the objectives of the organization set by the board of directors and the executive committee.

Today, I am pleased to report Food Fair, Inc. is a team of seasoned top management supported ably by lower echelons of managerial personnel qualified to assume more responsible roles in the Company.

I am confident of our ability to achieve significantly-improved growth in the years ahead because of the quality of the professional team we have assembled.

In closing, I wish to take note of the valuable services over many years of two directors, both retired Company officers, who have chosen not to stand for reelection at the annual meeting in November. They are Arthur S. Rosenberg, a director for 37 years, and Samuel P. Mandell, a director for 16 years.

In recognition of their contributions to the Company over the years, it is the intention of the board to appoint them honorary directors.

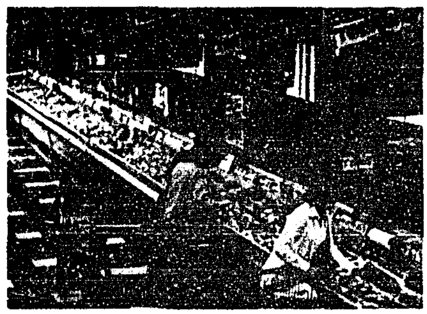
Sincerely,

Jack Friedland

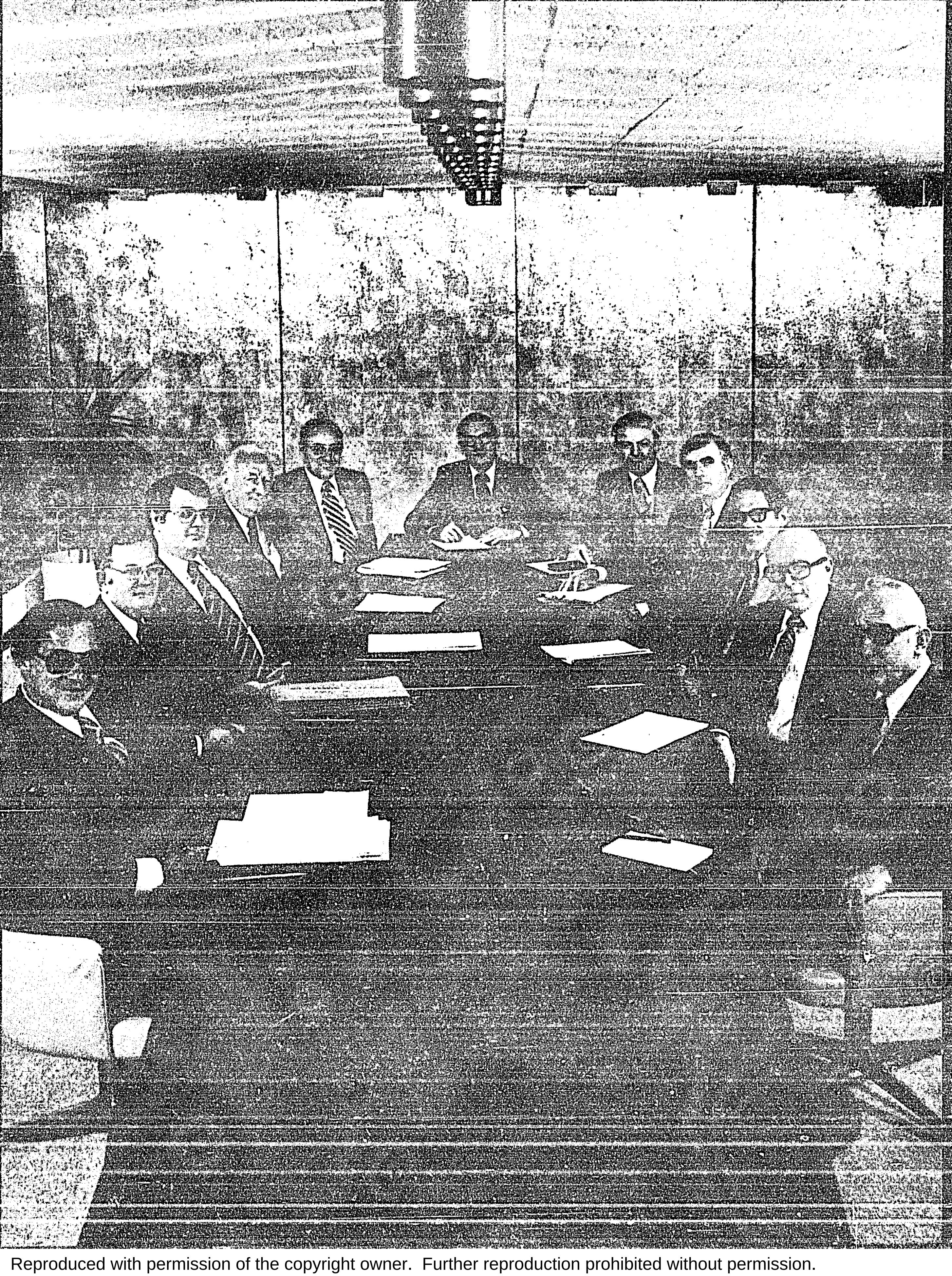
Jack Friedland
President
Chief Executive Officer

October 28, 1977

PRESIDENT'S STAFF COMMITTEE, a key advisory group which meets regularly with President Jack Friedland are, clockwise from extreme left Sidney Tucker, senior vice president, Tulip Real Estate Division, Marvin Kushner, senior vice president, Tulip Construction Division; Gerald Nathanson, corporate vice president and president, J. M Fields; J A Jonsson, corporate vice president-industrial relations; S Robert Silverman corporate vice president-distribution, Jack Friedland, J. A Berger, corporate vice president-manufacturing; Frank N James, corporate vice president and president, Pantry Pride; Marvin Lerner, executive vice president, Pantry Pride; Milton Russak, director, long-range planning, and Leo Dicandilo, corporate treasurer Not shown· Leonard Pasternak, president, Ideal Shoe Co



Consumer confidence in the quality of our fresh meat has been strengthened with introduction of the "Fresh Valley" USDA-Choice Grade beef program (photo, upper right) Many new Pantry Pride-label products have been added to self-service health and beauty aids sections (photo, lower right)



GROWING POPULARITY of live plant and related items sales in supermarkets has been recognized in this gift boutique designed for a recently-opened Penn Fruit store. Similar departments are planned for new and remodeled supermarkets.

YEAR IN REVIEW

Pantry Pride Supermarket Division

The Pantry Pride Supermarket Division recorded a net gain of 47 supermarkets in fiscal 1977, ending the year with 490 stores in 11 states along the east coast from Connecticut to Florida. Five new Pantry Pride supermarkets were opened and 60 units were acquired through the purchase of the Penn Fruit and Hills chains. Eighteen food units were closed.

In addition, 23 stores were remodeled including five which were enlarged and 13 conventional Food Fair markets in south Florida which were converted to discounting operations under the Pantry Pride name.

The 17 Penn Fruit stores acquired last October and the 43 Hills markets purchased in May enhanced our market position in the extremely competitive Philadelphia and metropolitan New York areas. The acquired stores continue to trade under the Penn Fruit and Hills names, but are integrated with our existing stores for operating and merchandising purposes.

In the last fiscal year, the supermarket division initiated a number of programs in response to changing socio-economic and competitive conditions.

Several of our stores in Florida have begun the sale of hot prepared foods for off-premises consumption to counter the convenience, fast-food restaurants growing share of the consumer's food dollar. Prepared foods sections in our appetizing departments offer a variety of hot entrees and vegetables for take-out. Additional pilot operations are planned.

The appetizing departments in new and remodeled stores have mini-bake shops where bread and rolls are baked on the premises. This feature and a "party platter" service, offering shoppers the opportunity to have party platters of luncheon meats, cheeses and other delicacies prepared to order by our personnel, have been a growing source of additional sales.

A program to build even greater consumer confidence in the quality of the meat sold in our supermarkets was launched with the introduction of "Fresh Valley" beef. This program with its emphasis on U.S. Dept. of Agriculture government-graded Choice beef sold under our exclusive Fresh Valley name has earned good consumer acceptance. An important feature of this consumer-confidence building is a date on the price sticker of each packaged beef item indicating when that item must be sold.

Fresh Valley meat is a major factor in the supermarket division-wide overall "Good Prices" campaign which stresses that our "good prices" are prices that represent consistent value on a continuing basis.

The marketing department has personalized the aggressive "Good Prices" merchandising initiative through a "Feel Good" program in which employe service to consumers is keyed to the theme: "We feel great when you feel good." This message is brought home most effectively in a series of television commercials featuring actual employes on the job and tied to a catchy "Feel Good" jingle.

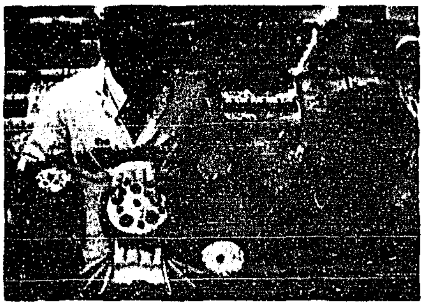
Our seafood departments have moved rapidly to "pan-ready" self-service merchandising. Pan-ready fish is cut, trimmed and attractively packaged, priced and dated for freshness. Time spent at the seafood counter waiting for service is eliminated.

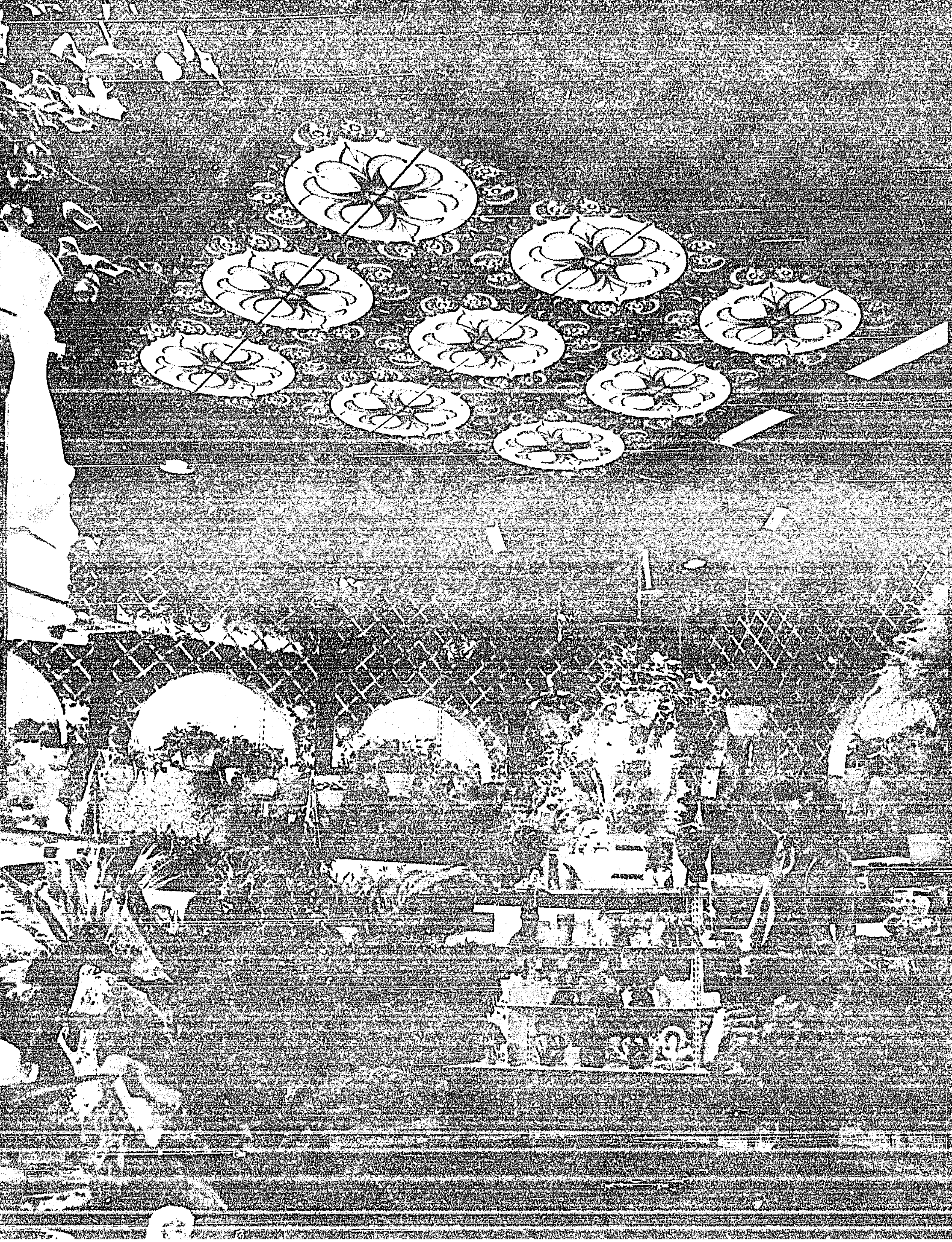
Produce departments are generating additional volume through the merchandising of live plants, flowers and related items. Special house plant sections have been built into new and remodeled stores, and in other stores arrangements are being made to introduce limited lines of these profitable items.

Consumers' more sophisticated tastes are also reflected in the wider variety of exotic cheese offered in our dairy and appetizing departments and the more extensive ethnic food sections in our grocery departments.

Increasingly greater space is being given to non-foods in new and remodeled stores. Non-foods, which include health and beauty aids and general merchandise, like housewares and soft goods, provide additional sales at higher profit margins than is traditional for groceries. In the last year, the supermarket division accelerated the introduction of additional Pantry Pride products, particularly to the health and beauty aids line. Pantry Pride label merchandise is competitive with the national brands in quality, but offers a considerable saving to consumers.

Party Platters-to-order is a new service for consumers offered by our appetizing departments (photo immediately below).
Saving cash register receipts for appliances is one of a number of "continuity" programs which have proved popular with shoppers (photo, bottom right).





HOT PREPARED FOODS TO-GO sections are being tested in several of our Florida supermarkets

In the grocery department, a second private-label line, Fyne Taste, has been introduced to supplement our Pantry Pride, top-of-the line. Fyne Taste represents an excellent alternative for shoppers at even greater savings.

"Continuity" programs have been effective in our sales-building efforts. Continuity programs offer consumers the opportunity to accumulate over a period of time dinner service, flat ware, encyclopedias or other gifts at substantial savings, or in some cases, with the accumulation of sales receipts, free. These programs help to counter split-shopping since the continuity offer is available only at our stores.

Consumer affairs department personnel continue to keep management attuned to consumer-related matters which may impact on operations. Consumer boards comprised of a cross-section of shoppers meet regularly with local area managements in valuable free-wheeling exchanges of views.

A Pantry Pride consumer education specialist makes frequent appearances on television and radio shows offering valuable food shopping, food preparation and nutritional information. Recipes, menus and other consumer aids prepared by the consumer affairs section are offered to shoppers and generate enthusiastic consumer response.

In recent years, computer technology has been applied increasingly to supermarket operations to improve efficiency and effect cost-savings. The most dramatic example to consumers is the automated checkout system where prices are scanned and recorded electronically eliminating the necessity to key punch prices on a register.

The division's first test of the computer-assisted scanning system was begun in February in the Pantry Pride store in Moorestown, N.J.

The scanner reads the Universal Product Code—the series of vertical lines on the product—and transmits the data to an in-store computer where the price is retrieved from a memory bank, displayed on a screen at checkout, and automatically printed on the shopper's receipt.

In addition to the benefits to consumers—decreased errors, faster service, itemized receipts—the system provides store management with online data on sales and product movement so that stock can be more efficiently managed. Consumer and employe acceptance of the new technology has been excellent.

While the scanning system is being evaluated, all new and remodeled stores are being equipped with the latest in electronic registers which are capable of collecting productivity and accounting data not possible with older registers. This information can be used to improve managerial control and utilize personnel more efficiently. New electronic registers simplify record-keeping at the store level, analyze in short-span time periods cashier productivity, indicate time-in-use of registers and permit speedy electronic flow of information from store to the computer terminal at headquarters.

The time-consuming task of check-cashing verification may be considerably eased through computer installations tied into banks. A variety of systems are under test throughout the supermarket division. In general, the systems provide verification of approvals in a matter of seconds through the use of special customer identification cards which are linked to central computers.

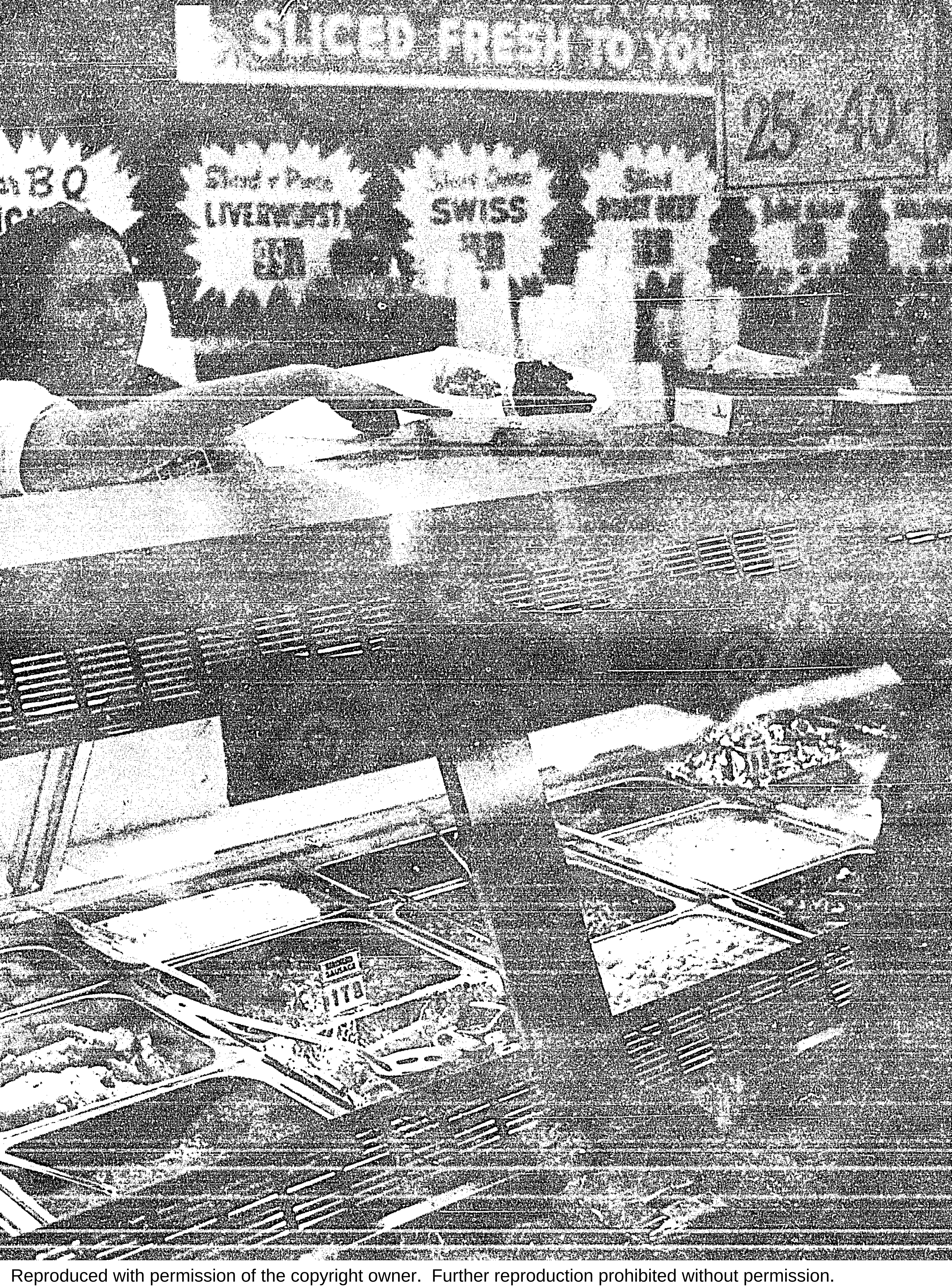
Computer application to warehousing has produced efficiencies hitherto unobtainable through less sophisticated systems. Computers enable management to maintain up-to-the-minute information and control of merchandise being received, stored and shipped out. The "on-line" system also designates location for the merchandise in the warehouse and the space available for storage. The system first tested in our Baltimore distribution center is being installed in our other warehouses.

An automatic reordering system to replenish warehouse inventories, based on past records of product movement, which was first tried successfully in our northern area warehouses, is now being implemented in our southern distribution centers.

Organizationally, for greater efficiency, our stores in the Allentown, Pa. area have been merged into our Philadelphia Region.

Pantry Pride loaves now appear in colorful, newly-designed wrappers (photo, immediately below).

Housewares represent an increasingly profitable source of sales in supermarkets (photo, bottom right)


SLICED FRESH TO YOU
LIVERWURST
SWISS

APPAREL DEPARTMENTS in J M Fields have been upgraded as part of an overall program of revising merchandise assortments and store layouts.

The Penn Fruit stores have been integrated into the Philadelphia Region and the Hills markets into the New York-Connecticut Region. Albert Faraldi, assistant vice president of the latter region, was promoted to the post of regional vice president.

Edwin Segal, director of operations for the Philadelphia Region, was promoted to Philadelphia Region vice president.

Leonard Slider, South Florida Region director of store operations, was promoted to South Florida Region vice president.

In the area of management development, the store manager training program has been revised and upgraded in line with the changing requirements of that position. More formalized training programs for district managers and other front line supervisors are being implemented, along with the tailoring of specific programs for other individuals in preparation for their assumption of more responsible positions.

J.M. Fields Discount Department Stores Division

Major steps were taken during the year to strengthen J.M. Fields with an infusion of new top-level management, a reorganization of the company's administrative-merchandising structure and a redesign of store layouts.

Gerald Nathanson joined J.M. Fields in January as president and chief executive officer. Mr. Nathanson, who had been president of Jefferson Stores, a successful discount department store chain in Florida, has assembled an experienced managerial team and reorganized and streamlined the division for more efficient operation.

The six senior vice presidents who with Mr. Nathanson comprise the top management are all seasoned executives in discount department store merchandising Elmer DiFilippo, senior vice president-retail merchandising, held a similar position at Jefferson Stores. Robert Floum, senior vice president-general merchandise manager-apparel, was vice president and general merchandise manager of ladies' and children's wear at Venture Stores.

Joseph Nusim, senior vice president-general merchandise manager-hard lines, had been vice president-general merchandise manager of hard and soft lines for Jamesway Corp. Henry Kirschner, senior vice president-operations, had been a divisional merchandise manager for Jefferson Stores after 10 years as vice president of Caribbean operations for Barkers discount department stores.

John Johnson, promoted to senior vice president and controller, had served in financial-accounting positions at Petrie Stores and Zayre Corp. before joining J.M. Fields in 1975 as treasurer Roy Reiner, promoted to senior vice president-imports with responsibility for all overseas buying offices and purchases of import merchandise, has many years of overseas buying experience, the last seven as managing director of Food Fair Overseas Ltd. in Hong Kong.

The 79 J.M. Fields stores have been split into two regions—North and South—and grouped into 12 districts of six to seven stores each, with a district manager providing daily supervision and counsel to store managers. At the regional level is a regional vice president and a staff comprised of a regional merchandise manager, personnel manager, auditor, security chief and major appliance supervisor.

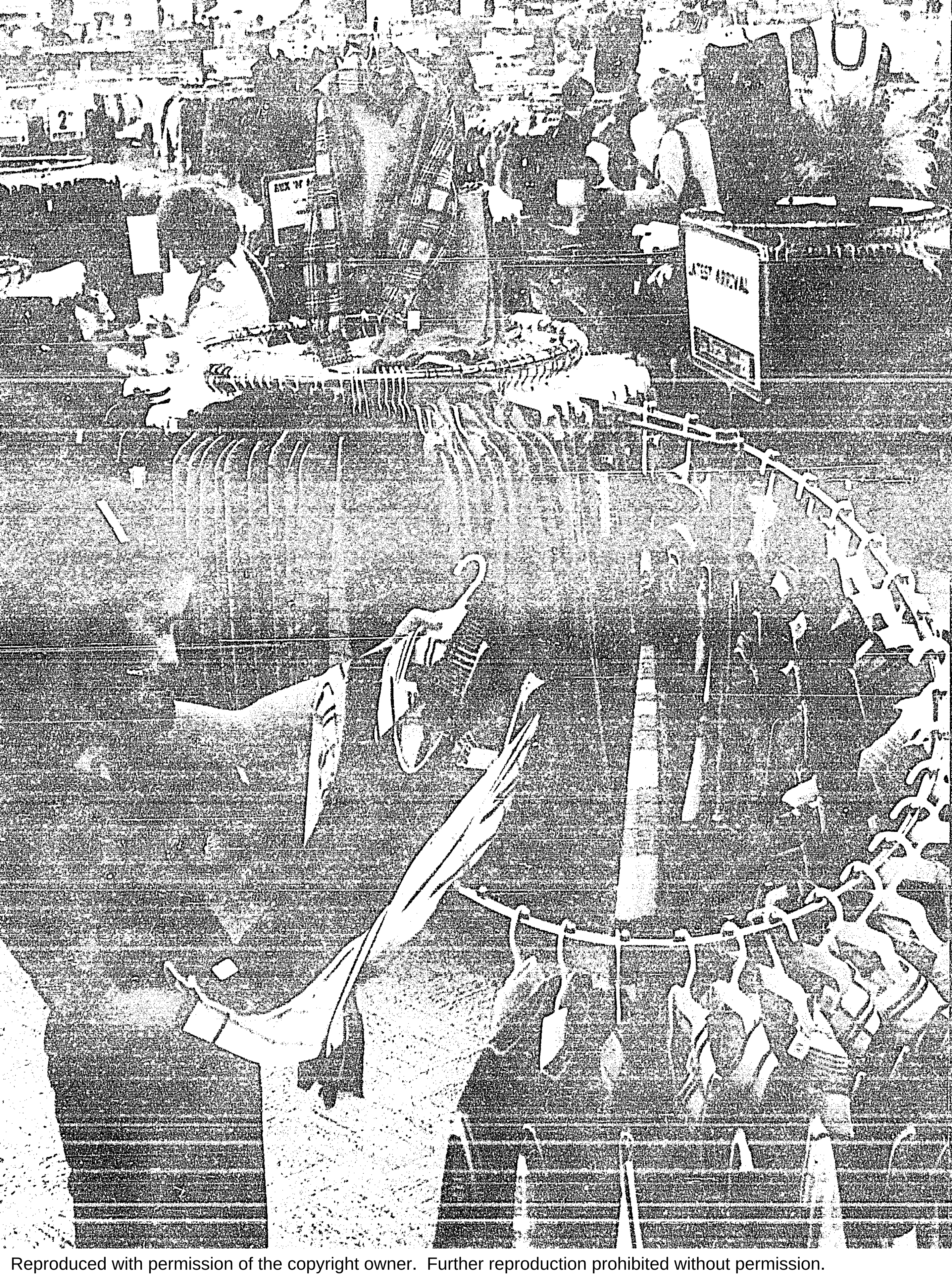
Department layouts have been revised, new display fixtures installed and store decor including perimeter wall signing changed.

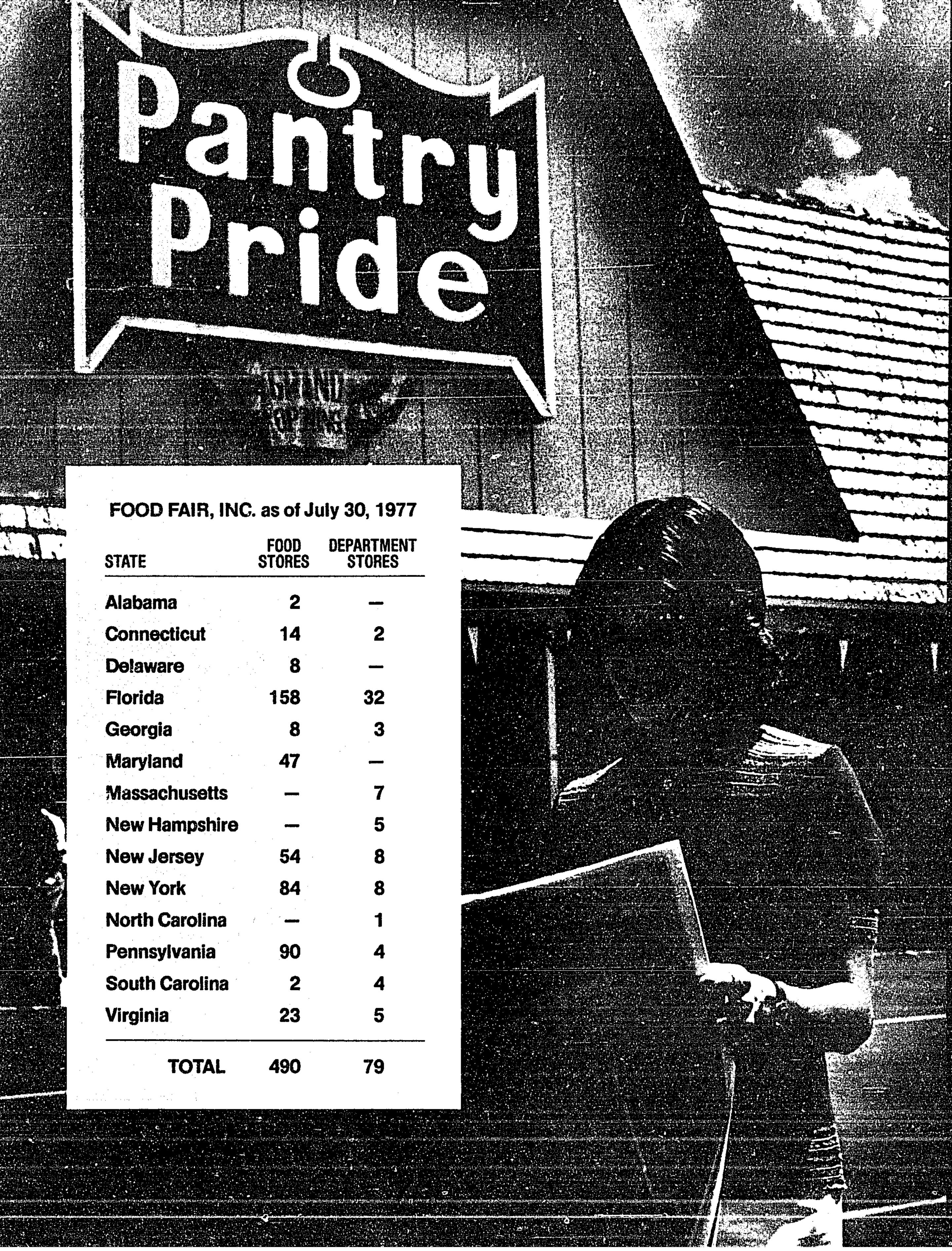
Merchandise lines, particularly fashion goods, women's and children's wear have been upgraded while still offering excellent value.

The staffing, organizational and store-design steps were taken in preparation for a major sales promotion program which was launched at the start of the new fiscal year, July 31, 1977.

The results of that campaign to date have been most encouraging. Sales have significantly increased Many new shoppers have been attracted to Fields' stores, responding to the excellent values in all departments heavily promoted by television, radio, newspaper and circular advertising.

Consumer response to the first months of the sales-building program gives hope for a substantial improvement in the performance of the discount department stores as the upward sales trend continues.


LATEST ARRIVAL



FOOD FAIR, INC. as of July 30, 1977

STATE	FOOD STORES	DEPARTMENT STORES
Alabama	2	—
Connecticut	14	2
Delaware	8	—
Florida	158	32
Georgia	8	3
Maryland	47	—
Massachusetts	—	7
New Hampshire	—	5
New Jersey	54	8
New York	84	8
North Carolina	—	1
Pennsylvania	90	4
South Carolina	2	4
Virginia	23	5
TOTAL	490	79

Financial Information

Five Year Summary of Operations

Food Fair, Inc. and Subsidiaries

	Year ended July 30, 1977 (52 weeks)	July 31, 1976 (52 weeks)	August 2, 1975 (52 weeks)	August 3, 1974 (53 weeks)	July 28, 1973 (52 weeks)
			(in thousands)		
Income:					
Sales	$2,436,702	$2,507,040	$2,482,539	$2,369,761	$2,092,127
Equity in earnings of uncondolidated subsidiaries	911	671	1,150	1,484	974
Gain on debentures purchased for sinking fund	129	697	290	282	384
Other	1,109	3,729	2,302	1,930	817
	2,438,851	2,512,137	2,486,281	2,373,457	2,094,302
Cost and expenses:					
Cost of sales	1,943,405	2,010,153	2,006,177	1,905,937	1,699,929
Operating, general and administrative expenses	481,425	480,611	473,535	442,452	374,057
Interest	11,532	11,513	13,831	11,833	12,018
	2,436,362	2,502,277	2,493,543	2,360,222	2,086,004
Income (loss) from continuing operations before income taxes	2,489	9,860	(7,262)	13,235	8,298
Income taxes (benefits)	(757)	3,284	(4,036)	4,175	1,954
Income (loss) from continuing operations	3,246	6,576	(3,226)	9,060	6,344
Loss from discontinued operations		2,748	208	134	182
Income (loss) before extraordinary items and accounting changes	3,246	3,828	(3,434)	8,926	6,162
Extraordinary items					(4,031)
Cumulative effect of accounting changes	4,175				
Net income (loss)	$ 7,421	$ 3,828	($ 3,434)	$ 8,926	$ 2,131
Earnings (loss) per share of common stock:					
Continuing operations	$ .43	$ .88	($ .45)	$ 1.20	$ .82
Discontinued operations		(.37)	(.03)	(.02)	(.02)
Income (loss) before extraordinary items and accounting changes	.43	.51	(.48)	1.18	.80
Extraordinary items					(.53)
Cumulative effect of accounting changes	.57				
Net income (loss)	$ 1.00	$ .51	($ .48)	$ 1.18	$ .27
Pro forma amounts assuming the new methods of accounting were applied retroactively (*):					
Income from continuing operations	$ 3,246	$ 6,946			
Net income	$ 3,246	$ 4,198			
Weighted average number of common share outstanding during the year	7,364,440	7,360,801	7,380,145	7,508,754	7,556,211
Cash dividends per share:					
Common share	$ .20	$ .20	$ .20	$ .20	$ .20
Preferred share	$ 4.20	$ 4.20	$ 4.20	$ 4.20	$ 4.20

*It was not practicable to determine the pro-forma amounts prior to 1976 assuming the new methods of accounting described in Note 2 to the consolidated financial statements were applied retroactively; however the effects on each year is considered to be immaterial

Management Analysis of Operations

1977 compared with 1976 and 1975

Supermarkets

Supermarket sales declined to $1,945 million from $1,962 million in 1976 and $1,966 million in 1975. Fiscal 1977 sales include the 17 Penn Fruit stores (14 operational) acquired October, 1976, and 43 Hills stores acquired May 7, 1977. Sales for 1977 and the fourth quarter were adversely affected by the residual effects of a three-week strike in the Philadelphia area which idled 93 stores in the third quarter. The lingering effects of the strike, together with heavy competitive pressures and promotional activities in all other areas, had an adverse impact on sales and profit margins.

Operating profits for the year were $32.0 million compared with $32.7 million in 1976 and $30.9 million in 1975. However, fourth quarter profits in 1977 were substantially below the comparable quarter in 1976. Strong promotional efforts were initiated in the 1977 fourth quarter to regain the lost sales. However, these programs did not bring about an immediate response in terms of higher sales in the quarter.

Total number of stores in operation at the end of 1977 were 490 compared with 443 in 1976 and 459 in 1975. Included in the increase in 1977 are the acquired Hills and Penn Fruit stores.

Discount Department Stores

Sales for the year decreased approximately 5% to $319 million from $335 million. In 1976, a 4% increase in sales was achieved over 1975 sales of $317 million. The decrease in 1977 occurred entirely in the third and fourth quarters. Fourth quarter sales were 16.5% below a year ago. A new management team, which assumed control in the second half of the fiscal year, made extensive changes in store layout, merchandising and store operations policies. Sales promotion activities were curtailed during the period until major aspects of these planned changes were implemented. Three fewer stores were in operation at fiscal year end, these units having closed in the third and fourth quarters. Three stores were also closed in 1976. In 1975, two units were opened and two closed.

Operating losses for the year increased to $9.8 million from $5.2 million in 1976. The increased loss in 1977 came about almost entirely in the third and fourth quarters and was caused by the decrease in sales volume and higher merchandise markdowns required to dispose of inventory not meeting the quality standards and policies of the new management team. An operating loss of $18.4 million was incurred in 1975. The improvement from 1975 to 1976 was brought about by improvements in the gross margin percentage and reduction in selling and administrative costs.

Other

"Other" operations representing primarily meat slaughtering and fabricating plant operations, incurred substantial declines in sales and operating profits. This was caused chiefly by a strike at the meat packing plant in Denver, Colorado, where operations were completely halted in the last two weeks of the first quarter and all of the second quarter. Full operating efficiency at the plant was not re-established until fiscal year end. In addition, there has been a continuing unfavorable relationship of prices of live cattle to dressed beef which further depressed profits in 1977.

Sales in 1977 fell to $173 million from $210 million in 1976. Sales in 1975 were $199 million. An operating loss of $1.9 million was incurred in 1977 compared with losses of $0.2 million in 1976 and $0.3 million in 1975. Prior years' figures for "Other" operations have been restated to reflect reclassification of certain retail-related, non-food manufacturing operations into the Discount Department Stores Division.

Interest and Overhead

There was no change in the interest expense for fiscal 1977 from 1976. Interest expense declined to $11.5 million in 1976 from $12.8 million in 1975. Corporate overhead increased from $5.7 million in 1975 to $6.0 million in 1976 and $6.5 million in 1977.

Discontinued Operations of Affiliated Company

In 1976, a loss of $2.7 million was incurred which represented the Company's equity in the loss of Amterre Development Inc This resulted from a transfer of certain property to the mortgagee in satisfaction of first mortgages on the property. No losses were incurred in 1977 or 1975.

Accounting Changes

The cumulative effect on prior years of accounting changes implemented during 1977 increased net income by $4.2 million. These changes are more fully described in Note 2 to the consolidated financial statements.

Operating Results by Lines of Business

Food Fair, Inc. and Subsidiaries

	Year ended nearest July 31:				
				(53 weeks)	
	1977	1976	1975	1974	1973
			($ in millions)		
Sales:					
Supermarket operations	$1,945.2	$1,962.3	$1,966.3	$1,893.6	$1,591.8
Discount department stores*	318.8	334.9	317.2	326.3	321.6
Other*	172.7	209.8	199.0	149.8	178.7
Total sales	$2,436.7	$2,507.0	$2,482.5	$2,369.7	$2,092.1
Operating profit (loss):					
Supermarket operations	$ 32.0	$ 32.7	$ 30.9	$ 34.7	$ 21.0
Discount department stores*	(9.8)	(5.2)	(18.4)	(8.1)	2.3
Other*	(1.9)	(.2)	(.3)	3.5	1.8
Total operating profit	20.3	27.3	12.2	30.1	25.1
Unallocated expenses:					
Interest	11.5	11.5	13.8	11.9	12.0
Corporate overhead	6.3	6.0	5.7	5.1	5.0
Total unallocated expenses	17.8	17.5	19.5	17.0	17.0
Earnings (loss) before income taxes, discontinued operations and cumulative effect of accounting changes	$ 2.5	$ 9.8	$ (7.3)	$ 13.1	$ 8.1

*Sales and operating profit (loss) of a shoe manufacturing operation have been reclassified from Other to Discount department stores in 1976 and prior years to conform with the 1977 presentation as follows:

	1977	1976	1975	1974	1973
Sales	$ 16.0	$ 11 3	$ 6.4	$ 7.8	$ 7.7
Operating profit (loss)	$ 1.3	$ 0.6	$ (0.2)		$ 0.4

Food Fair, Inc and Subsidiaries

Consolidated Statement of Income

Fifty-Two Weeks Ended July 30, 1977 and July 31, 1976

	1977	1976
Income:		
Sales	$2,436,702,000	$2,507,040,000
Equity in earnings of unconsolidated subsidiaries	911,000	671,000
Gain on debentures purchased for sinking fund	129,000	697,000
Other	1,109,000	3,729,000
	2,438,851,000	2,512,137,000
Costs and expenses:		
Cost of sales	1,943,405,000	2,010,153,000
Operating, general and administrative expenses	481,425,000	480,611,000
Interest	11,532,000	11,513,000
	2,436,362,000	2,502,277,000
Income from continuing operations before income taxes	2,489,000	9,860,000
Income taxes (credit) (Note 11)	(757,000)	3,284,000
Income from continuing operations (Note 2)	3,246,000	6,576,000
Equity in loss of discontinued operations of unconsolidated subsidiary, net of income tax benefit of $185,000 (Note 6)		(2,748,000)
Cumulative effect on prior years (to August 1, 1976) of changes in accounting methods (Note 2)	4,175,000	
Net income	$ 7,421,000	$ 3,828,000
Earnings per share of common stock:		
Income from continuing operations	$ .43	$ .88
Loss from discontinued operations		(.37)
Cumulative effect of changes in accounting methods	.57	
Net income	$ 1.00	$ .51
Pro forma amounts assuming the new methods of accounting were applied retroactively (Note 2):		
Income from continuing operations	$ 3,246,000	$ 6,946,000
Earnings per share of common stock	$ .43	$ .93
Net income	$ 3,246,000	$ 4,198,000
Earnings per share of common stock	$ .43	$ .56

Food Fair, Inc and Subsidiaries

Consolidated Statement of Retained Earnings

Fifty-Two Weeks Ended July 30, 1977 and July 31, 1976

	1977	1976
Balance, beginning of year, as previously reported	$ 75,377,000	$ 73,632,000
Restatement, net of income tax (Note 2)		(521,000)
Balance, beginning of year, restated	75,377,000	73,111,000
Net income for the year	7,421,000	3,828,000
	82,798,000	76,939,000
Cash dividends paid:		
Preferred stock ($4.20 per share)	76,000	89,000
Common stock ($.20 per share)	1,472,000	1,473,000
	1,548,000	1,562,000
Balance, end of year	$ 81,250,000	$ 75,377,000

See notes to consolidated financial statements

Food Fair, Inc and Subsidiaries

Consolidated Balance Sheet

July 30, 1977 and July 31, 1976

Assets

	1977	1976 (Restated, Note 2)
Current assets:		
Cash	$ 10,591,000	$ 16,588,000
Marketable securities	59,000	52,000
Accounts receivable, net of allowance for doubtful accounts, $1,057,000, 1977; $698,000, 1976	22,210,000	20,187,000
Inventories	260,499,000	237,860,000
Prepaid expenses	12,655,000	10,946,000
Advances to Fields Credit Corp. (Note 5)		2,327,000
Recoverable income taxes	2,569,000	
Total current assets	308,583,000	287,960,000
Investments (Notes 5 and 6):		
Fields Credit Corp.	488,000	6,432,000
Amterre Development Inc. (including advances of $1,819,000, 1977; $1,707,000, 1976)	7,879,000	7,944,000
Other subsidiaries	7,806,000	6,378,000
Miscellaneous	634,000	843,000
	16,807,000	21,597,000
Property, plant and equipment:		
Real estate, net of accumulated depreciation (Note 7)	25,383,000	25,088,000
Other:		
Leasehold improvements	57,017,000	45,326,000
Fixtures and equipment	143,445,000	131,015,000
	200,462,000	176,341,000
Less accumulated depreciation	108,559,000	91,282,000
	91,903,000	85,059,000
	117,286,000	110,147,000
Other assets:		
Accounts and notes receivable, not current (Note 4)	10,947,000	7,395,000
Excess of cost over net assets of businesses acquired, net of amortization	1,996,000	2,056,000
Deferred charges	2,469,000	3,476,000
Miscellaneous	1,637,000	1,711,000
	17,049,000	14,638,000
	$459,725,000	$434,342,000

See notes to consolidated financial statements.

Liabilities and Shareholders' Equity

	1977	1976 (Restated, Note 2)
Current liabilities:		
Notes payable (Note 8)	$ 14,045,000	$ 30,522,000
Current portion of long-term debt (Note 8)	14,376,000	9,119,000
Accounts payable	109,725,000	102,180,000
Accrued salaries and other expenses	39,094,000	40,464,000
Income taxes, including current portion of deferred tax (Note 11)	3,219,000	4,105,000
Total current liabilities	180,459,000	186,390,000
Long term debt (Note 8):		
Mortgages payable on real estate	15,052,000	15,417,000
Other	112,517,000	85,486,000
	127,569,000	100,903,000
Deferred income (Note 9)	1,379,000	1,618,000
Deferred income tax (Notes 2 and 11)	9,501,000	10,354,000
Minority interest in subsidiaries	361,000	311,000
Commitment and contingencies (Notes 4, 13 and 14)		
Shareholders' equity (Notes 8 and 10):		
Preferred stock	1,747,000	1,960,000
Common stock	7,557,000	7,557,000
Capital in excess of par	51,239,000	51,189,000
Retained earnings	81,250,000	75,377,000
	141,793,000	136,083,000
Less cost of common stock held in treasury	1,337,000	1,317,000
	140,456,000	134,766,000
	$459,725,000	$434,342,000

Statement of Changes in Financial Position

Fifty-Two Weeks Ended July 30, 1977 and July 31, 1976

	1977	1976 (Restated, Note 2)
Source of funds:		
Net income for the year	$ 7,421,000	$ 3,828,000
Items not affecting working capital:		
Depreciation	17,252,000	17,379,000
Amortization	299,000	316,000
Deferred income (Note 9)	(239,000)	(2,852,000)
Deferred income tax	(853,000)	
(Earnings) loss of unconsolidated subsidiaries:		
Continuing operations	(911,000)	(740,000)
Discontinued operations		2,748,000
Working capital provided from operations	22,969,000	20,679,000
Disposition of property, plant and equipment	2,673,000	1,755,000
Increase in long-term debt	42,453,000	2,030,000
Deferred income on sale of computer programs (Note 9)		1,618,000
Repayment of subordinated notes, Fields Credit Corp	5,900,000	
	73,995,000	26,082,000
Application of funds:		
Purchase of property, plant and equipment	16,229,000	11,873,000
Decrease in long-term debt	22,139,000	12,160,000
Increase in:		
Other assets	2,710,000	1,761,000
Investments	201,000	1,375,000
Payment of cash dividends	1,548,000	1,562,000
Purchase of businesses (Note 3):		
Property and equipment	10,835,000	
Long-term debt	(6,352,000)	
Prior period adjustment of accrued vacation payroll (Note 2)		521,000
Other changes, net	131,000	137,000
	47,441,000	29,389,000
Increase (decrease) in working capital	$26,554,000	($ 3,307,000)
Summary of net changes in working capital:		
Increase (decrease) in current assets:		
Cash	($ 5,997,000)	($13,101,000)
Marketable securities	7,000	(385,000)
Accounts receivable	2,023,000	3,215,000
Inventories	22,639,000	23,090,000
Prepaid expenses	1,709,000	335,000
Advances to Fields Credit Corp.	(2,327,000)	1,329,000
Recoverable income taxes	2,569,000	(2,723,000)
	20,623,000	11,760,000
Increase (decrease) in current liabilities:		
Notes payable	(16,477,000)	15,424,000
Current portion of long-term debt	5,257,000	2,374,000
Accounts payable	7,545,000	(6,366,000)
Accrued salaries and other expenses	(1,370,000)	361,000
Income taxes	(886,000)	3,274,000
	(5,931,000)	15,067,000
Increase (decrease) in working capital	$26,554,000	($ 3,307,000)

 See notes to consolidated financial statements

1. Summary of significant accounting policies:

Fiscal year: The fiscal year of the Company ends on the Saturday nearest to July 31. The 1977 and 1976 fiscal years each comprised 52 weeks.

Basis of consolidation: The consolidated financial statements include the accounts of the Company and its wholly and majority owned subsidiaries, except the life insurance and credit companies. All significant intercompany balances and transactions have been eliminated. Intercompany profits, if any, in the inventories, are not significant.

Investments in the life insurance and credit companies, 50% owned companies and the common stock of Amterre Development Inc are stated at the Company's equity in net assets. The investment in the preferred stock of Amterre Development Inc is stated at cost, equivalent to its liquidating value.

Inventories: Inventories are stated at the lower of cost or market, with cost being determined as follows: inventories in stores—retail method, inventories in warehouses—principally average cost; inventories at manufacturing facilities and supplies—cost on a first-in, first-out method.

Property, plant and equipment and depreciation: Property, plant and equipment are stated at cost. Depreciation is computed on the straight-line method over the estimated useful lives of the assets.

Other assets: Excess of cost over net assets of businesses acquired is being amortized over a forty-year period.

Net losses incurred in the initial three months by new stores, remodeled or converted stores are deferred and amortized over a three year period.

Debt expense is being amortized over the term of the debentures. If debentures are retired prior to maturity, the unamortized expense is charged to operations.

Computer system costs incurred in the acquisition, development or improvement of software related to administrative operations are deferred and being amortized over a period of five years from the date the costs are incurred.

Income taxes: Deferred income taxes result from timing differences in the recognition of certain income and expense items for financial reporting and income tax reporting purposes, such as the acceleration of depreciation and insurance claims receivable. Amounts applicable to current assets are included in current liabilities. Investment tax credits are accounted for under the "flow-through" method when the assets are placed in service.

Pension plans: Pension expense includes normal cost and amortization of prior service costs over a forty-year period. Pension plan costs are funded as accrued.

Net income per common share: Net income per common share is based on the weighted average number of shares outstanding during the year. Warrants and convertible subordinated notes have no significant dilutive effect.

Reclassification: The financial statements for 1976 have been reclassified to conform with the presentation for 1977.

2. Accounting changes:

In the fourth quarter of 1977, the Company changed certain methods of accounting in order to provide a better matching of revenues and expenses and to improve interim financial reporting as follows: (1) the inclusion of warehousing costs in the determination of supermarket inventories; (2) the amortization of payroll tax expense over the entire year; (3) the computation of deferred income taxes on the gross change method.

Previously, warehousing costs and payroll taxes were charged to income as incurred. Deferred income taxes were recorded on the net change method.

The effect of these changes for the current year resulted in an increase in income from continuing operations of $318,000 or $.04 per share. The cumulative effect of these changes on years prior to August 1, 1976, approximately $4,175,000 (net of $2,217,000 for income taxes) or $.57 per share, has been credited to operations in 1977. The effect on net income of each of these changes in accounting methods is as follows:

	Cumulative effect to August 1, 1976		Effect on year ended July 30, 1977		Pro forma effect on year ended July 31, 1976	
	Amount	Per share	Amount	Per share	Amount	Per share
	(in thousands, except per share amounts)					
Warehouse overhead	$1,540	$.21	$ 98	$.01	$186	$.03
Payroll taxes..	798	.11	220	.03	184	.02
Deferred income taxes..	1,837	.25	None	None	None	None
	$4,175	$.57	$318	$.04	$370	$.05

2. Accounting changes (continued):

Retained earnings at August 3, 1975 have been restated by a charge of $521,000, net of $482,000 of income tax, to increase accrued vacation payroll. This correction had an immaterial effect on net income reported for 1976 and prior years.

As of July 30, 1977, the Company revised its estimate of the liability for trading stamp redemptions, the effect of which was to increase income from continuing operations and net income for 1977 by $858,000 ($.12 per share).

3. Acquisitions:

On October 7, 1976, the Company acquired for cash the business assets, net of certain liabilities, of 17 supermarkets formerly owned by Penn Fruit Co., Inc. (Penn Fruit), for $3,926,000. This acquisition was accounted for as a purchase and the net assets were recorded based upon their estimated fair values. Operations of the acquired supermarkets are included in the consolidated statement of income from the date of acquisition.

On May 7, 1977, the Company acquired for cash all of the outstanding capital stock of Hills Supermarket, Inc. (Hills) for $8,202,000. At the date of acquisition, Hills operated 43 supermarkets in the Long Island, New York area. The total cost exceeded the net assets of Hills by approximately $345,000, which amount was assigned to fixtures and equipment and is being amortized generally over the remaining lives of the acquired assets. The acquisition was accounted for as a purchase and the financial statements include the operations of Hills from the date of acquisition.

The businesses acquired in the above transactions were only a portion of the aggregate operations of the two companies in prior periods, and because of the nature and extent of significant adjustments made at the date of the Hills acquisition, it is not practicable to present, on a pro forma basis, combined results of operations for 1977 and 1976 as though the businesses had been combined as of the beginning of 1976. Pro forma combined sales of the Company and the acquired businesses are as follows:

	1977	1976
	(in thousands)	
Food Fair, Inc. and Subsidiaries.......	$2,328,062	$2,507,040
Penn Fruit and Hills..	274,082	342,833
Combined.....	$2,602,144	$2,849,873

4. Contingencies:

Accounts and notes receivable, not current includes $5,289,000, representing the excess of workmen's compensation, automobile and general liability claims and adjustors' fees paid above the deductible amount provided for in the related insurance policies. The insurance carrier has denied liability for the claims, and seeks to rescind the insurance coverage by alleging misrepresentation of certain information furnished to the insurer prior to issuance of the policies. Counsel for the Company have advised that on the basis of extensive although not yet complete deposition testimony, and other discovery with the principal agents and employees of plaintiff, plaintiff has not come forward with evidence sufficient to sustain its claim for rescission. The Company has filed counterclaims seeking to recover the excess payments. It is not presently possible to predict the outcome of this matter. At July 31, 1976, the insurance claims amounted to $1,427,000 and were included in prepaid expenses.

Subsequent to the termination of the coverage discussed in the preceding paragraph, the Company elected to self-insure individual claims of $100,000 or less for workmen's compensation, automobile and general liability risks. An estimate of $650,000 has been included in current liabilities for existing conditions which are expected to be settled currently. It can not be determined whether the Company will be required to make payments to claimants in excess of $650,000, and if so required, whether such amounts will be material.

The Federal income tax returns of the Company and certain subsidiaries have been examined by Internal Revenue Service for 1964 through 1968. The service has proposed adjustments which would result in additional taxes of approximately $6,200,000, exclusive of interest. Since the material issues are being litigated, it is not presently possible to estimate the ultimate outcome of the tax controversies.

In connection with the 20% interest which the Company holds in Hamilton Investment Trust, the Company, together with others, was named in March 1977 as a defendant in a class action which alleges violations of certain sections of the Federal Securities Laws as well as common law principles. The plaintiffs seek damages of an unspecified and undetermined amount. The defendants have moved to dismiss the complaint, however the outcome of this litigation is uncertain.

The Company, together with numerous other retail food companies and others, has been named as a defendant in multiple civil actions brought in various United States District Courts by certain cattle producers and feeders alleging violations of the anti-trust laws in connection with the purchase and re-sale of beef. The cases, most of which have been or are anticipated to be consolidated for pre-trial purposes in the United States District Court, Northern District of Texas, seek damages in an unspecified amount and an injunction against further anti-trust violations as alleged. Management believes that no basis exists for the allegations made against the Company and, after consultation with counsel, is of the opinion that these actions will not have a material adverse effect on the financial condition of the Company. Further, in October 1977, the Company was advised that the United States District Court in Texas had determined to dismiss the cases consolidated before it upon the grounds that under a recent decision of the United States Supreme Court the plaintiffs lacked standing to sue. Such dismissal does not apply to cases not consolidated before the court.

The Company is party to various other claims and lawsuits arising in the normal course of business. In the opinion of management the outcome of the various actions will not materially affect the Company's financial condition.

The Company is contingently liable at July 30, 1977, for accounts receivable aggregating $19,789,000 sold to banks with recourse.

5. Investment, Fields Credit Corp.:

Fields Credit Corp. is presently inactive due to the Company's decision to discontinue customer charge sales. During 1977, the $5,900,000 subordinated notes due the Company were repaid.

6. Investment, Amterre Development Inc (Amterre):

The Company owns all of the preferred stock and 40% of the common stock of Amterre. At July 30, 1977, the value of the preferred stock was $2,000,000 (Note 1) and the market value of the common stock was $5,000,000 based on a quoted bid price of $1.50 per share.

Condensed financial statements of Amterre are as follows:

Consolidated balance sheet:	December 31, 1976	December 31, 1975
	(in thousands)	
Assets		
Property and equipment, at cost, net of accumulated depreciation	$179,069	$182,450
Net property and related assets in process of disposition		60,245
Less:		
Related mortgages and other liabilities		(48,857)
Provision for loss on disposition		(11,388)
		—0—
Other assets	11,466	11,451
	$190,535	$193,901
Liabilities and Equity		
Notes, mortgages and debentures payable	$170,446	$172,442
Construction loans payable	2,741	4,141
Other	4,891	4,498
	178,078	181,081
Shareholders' equity	12,457	12,820
	$190,535	$193,901

Consolidated statement of operations:	Year ended December 31, 1976	Year ended December 31, 1975
	(in thousands)	
Income	$29,122	$27,474
Expenses, net	29,411	27,892
Loss from continuing operations before income taxes	(289)	(418)
Income taxes (benefit)	52	(137)
Loss from continuing operations	(341)	(281)
Income (loss) from discontinued operations, net of income tax benefit	98	(7,333)
Net loss	($ 243)	($7,614)

The accountants' report on the examination of the financial statements of Amterre for the year ended December 31, 1976, was qualified with respect to Amterre's full recovery of its investments in a parcel of land and a joint venture. In the opinion of management, any loss which might be sustained by Amterre in the realization of these investments, will not have a material effect on the financial position or results of operations of the Company.

Net property and equipment and related assets in process of disposition and the loss from discontinued operations relate to the Gateway Urban Renewal Project in Newark, New Jersey. Effective April 1, 1976, the property was transferred to the mortgagee in satisfaction of the first mortgages on the properties.

The Company's equity in Amterre's loss from continuing operations was $267,000 in 1977 and $160,000 in 1976, which amounts are included in the caption "Equity in earnings of unconsolidated subsidiaries" and have been adjusted to provide for dividends paid on preferred stock. The 1977 amount includes a provision for Amterre's loss for the six months ended July 30, 1977.

The Company is obligated to Amterre under 96 leases expiring through 2057. The minimum annual rentals applicable to such leases have been included in the lease obligations set forth in Note 14.

7. Real estate:	1977	1976
	(in thousands)	
Land	$12,624	$12,127
Buildings	18,818	18,469
	31,442	30,596
Less accumulated depreciation	6,059	5,508
	$25,383	$25,088

8. Indebtedness:

	Rate	1977	1976	Maturity
		(in thousands)		
Current:				
Notes payable (a)	Prime	$ 14,045	$ 30,522	
Long term:				
Notes:				
Banks (b)	Prime to 8%	$ 55,149	$ 21,296	1977-1983
Other	5%-9%	8,835	6,632	1978-1984
Mortgages, land and buildings pledged as collateral	4.75%-10.5%	15,830	16,234	1979-2001
Convertible subordinated notes (c)	4%		480	1977
Subordinated debentures (d)	4%	11,204	11,941	1979
Subordinated notes (d)	8.5%	19,000	21,000	1984
Sinking fund debentures (d)	8.375%	31,927	32,439	1996
		141,945	110,022	
Less current portion		14,376	9,119	
		$127,569	$100,903	

(a) At July 30, 1977, the Company had lines of credit available from various banks totalling $31,700,000 at the prevailing prime interest rate; of this amount $24,000,000 was unused. These lines are supported by the Company's normal cash balances maintained on a daily basis and there is no legal restriction on the availability of such balances. During fiscal 1977, short term borrowings averaged approximately $29,360,000 (maximum $50,500,000) at an average interest rate of 6.5%. The Company also has available letters of credit from various banks totalling $11,500,000, of which $4,278,000 were included in accounts payable at July 30, 1977.

(b) Includes $39,000,000 advanced under a revolving credit agreement entered into on June 1, 1977, providing for borrowings on a revolving basis, up to $50,000,000 from a group of banks. The loans bear interest at ½% above prime and mature on March 31, 1979, subject to extension, under certain conditions, to March 31, 1980. Initial advances of $36,400,000 were used to repay short term bank debt. Additional amounts will be used for working capital, new equipment and the remodeling of existing stores.

(c) The notes were repaid during 1977.

(d) Annual sinking fund or note payments are required as follows:

Subordinated debentures	$ 967,000
Subordinated notes	2,000,000
Sinking fund debentures	1,750,000

The agreements and indentures covering the notes and debentures described above contain certain covenants relating to the payment of cash dividends, the redemption of shares of stock of the Company, working capital and shareholder's equity. The maximum amount of retained earnings so restricted was $63,067,000 at July 30, 1977.

9. Deferred income:

On May 7, 1976, the Company sold all of its data processing programs and certain computer equipment to RMC Group, Inc. (RMC), a company which has managed the Company's electronic data processing operations. The equipment and computer programs acquired by RMC are being utilized to provide similar services to third parties. Payment consisted of cash of $200,000 and a nonrecourse promissory note of $1,600,000. The note is payable over seven years with interest at 7% and is secured by the equipment and programs.

The Company entered into an agreement with RMC to manage and operate its computer operations for a period of seven years. During the year ended July 30, 1977, fees of $7,110,000 were paid to RMC, of which $799,000 have been deferred as software development costs. The gain on the sale of equipment and programs of $1,680,000, was deferred in 1976 and is being credited to income over the term of the management agreement. In 1977, $239,000 was credited to income.

RMC granted the Company an option, exercisable after January 14, 1979, and until November 8, 1979, to acquire, for $1,000,000, a 40% stock interest in RMC.

10. Capital stock and capital in excess of par:

The $4.20 cumulative preferred stock, $15 par, is stated at the liquidating value of $100 per share; 108,190 shares are authorized, of which 17,465 and 19,601 are outstanding at July 30, 1977, and July 31, 1976, respectively. The Company is obligated to set aside $120,000 semi-annually as a sinking fund for the redemption of the preferred stock, which may be called for this purpose at $100 per share plus accrued dividends. The decrease in preferred stock in 1977 represents the stated value of 2,136 shares retired.

Common stock is $1 par; 10,000,000 shares are authorized, of which 7,557,378 are issued. Shares acquired for the treasury are 199,101 and 196,577 at July 30, 1977 and July 31, 1976, respectively.

At July 30, 1977, warrants to purchase 416,160 shares of common stock were outstanding. These warrants are exercisable at $23.05 per share and expire December 17, 1979. See Note 13 for stock purchase agreement.

The increase in capital in excess of par during 1977 represents the excess of stated value over cost of preferred stock retired.

11. Income taxes:

	1977	1976
	(in thousands)	
Federal:		
Current (credit)	($ 185)	$2,972
Investment tax credit	(1830)	(994)
State	700	713
Deferred	558	593
	($ 757)	$3,284

A reconciliation of income taxes from continuing operations with the amount computed at the Federal income tax rate of 48% is as follows:

	1977	1976
	(in thousands)	
Computed "expected" income tax expense	$1,195	$4,764
State income taxes, net of Federal tax effect	364	371
Federal income tax refunds	(689)	
Tax benefit from:		
Income taxed at capital gains rate	(102)	(381)
Dividend income not taxable	(80)	(66)
Investment tax credit	(1,830)	(994)
Net earnings of unconsolidated subsidiaries taxed at reduced rates	433	(250)
Other items, net	(48)	(160)
Income tax on income from continuing operations	($ 757)	$3,284

The aggregate investment tax credit applied in reduction of income tax expense is $1,830,000 and $994,000 in 1977 and 1976, respectively. Federal income tax refunds in 1977 result from Internal Revenue Service examinations. In accordance with the early adoption provisions of Statement of Financial Accounting Standards No. 16, these refunds have been used to reduce 1977 income tax expense.

The Company and its subsidiaries file a consolidated Federal income tax return. At July 30, 1977, the Company has available for Federal income tax purposes, investment tax credit carryforwards expiring as follows: $500,000 in 1978; $1,300,000 in 1979; $1,700,000 in 1980; $900,000 in 1981; $1,200,000 in 1982; $100,000 in 1983; and $1,800,000 in 1984.

In connection with the acquisition of Hills (Note 3), net operating loss carryforwards of approximately $27,000,000 are available to reduce future taxable income of Hills. Substantially all of these carryforwards expire between 1983 and 1985.

12. Pension plans:

The Company and its subsidiaries have various non-contributory pension plans covering certain hourly and salaried employees. Pension expense for 1977 and 1976 was $1,464,000 and $1,287,000, respectively. The actuarially computed value of vested benefits for certain plans at January 1, 1977, exceeded fund assets and balance sheet accruals by approximately $1,933,000. The total unfunded prior service cost of the plan is estimated to be $8,544,000 at January 1, 1977.

13. Commitment:

The Company has entered into an employment contract with an officer, providing for a minimum annual salary of $200,000 through 1982, plus a bonus based upon the achievement of defined levels of discount department store earnings, up to a maximum annual compensation of $450,000. The officer is obligated to purchase 100,000 shares of the Company's common stock at $5.625 per share through August 1, 1982 and 100,000 shares at $6.00 per share through August 2, 1987. Purchases of the latter shares may not exceed 10,000 in any twelve month period. No purchases have been made under the agreement.

14. Leases:

The Company was lessee under leases covering principally retail locations and distribution centers. Realty lease terms generally range to twenty-five years, with options of renewal for additional periods. Equipment leases expire at various dates through 1985.

The Company has made a distinction between financing lease arrangements and other lease arrangements. Total rental expenses, net of sublease rental income, for the years ended July 30, 1977 and July 31, 1976 is as follows:

	1977	1976
	(in thousands)	
Financing leases:		
Minimum rentals	$23,553	$22,020
Rentals based on sales	269	452
Sublease rentals	(2,788)	(2,577)
	21,034	19,895
Other leases:		
Minimum rentals	18,433	14,870
Rental based sales	1,328	1,422
Sublease rentals	(857)	(886)
	18,904	15,406
Total rent expense	$39,938	$35,301

Rental expense for financing leases includes payments to unconsolidated affiliated real estate companies of $13,472,000 and $13,504,000 in 1977 and 1976, respectively.

Minimum rental commitments, exclusive of taxes and other costs paid by the Company, are approximately as follows:

				Sublease rental income	
Years	Net all leases	Financing leases	Other leases	Financing leases	Other leases
	(in thousands)				
1978	$ 38,172	$ 23,469	$ 18,047	($ 2,564)	($ 780)
1979	37,121	23,443	16,535	(2,107)	(750)
1980	35,976	23,151	15,227	(1,839)	(563)
1981	33,624	22,002	13,622	(1,485)	(515)
1982	31,344	21,398	11,456	(1,103)	(407)
1983-1987	119,490	81,459	42,960	(3,718)	(1211)
1988-1992	76,775	54,078	24,951	(1,843)	(411)
1993-1997	41,577	37,216	5,507	(1,092)	(54)
Thereafter	11,477	6,191	5,479	(193)	
	$425,556	$292,407	$153,784	($15,944)	($4,691)

The present value of the minimum lease commitments for financing leases was $166,255,000 at July 30, 1977 and $180,158,000 at July 31, 1976, based on calculations using interest rates ranging from 4.25% to 11.75%. The weighted average interest rates were 7.09% and 6.96% for 1977 and 1976, respectively.

If, instead of recording rental expense, all financing leases were capitalized, related assets were amortized on a straight-line basis and interest costs were accrued on the outstanding lease liability, the effect on net income would be as follows:

	1977	1976
	(in thousands)	
Amortization of lease rights	$11,582	$11,171
Interest costs	12,680	12,858
	24,262	24,029
Rental expense	23,833	22,472
	429	1,557
Allocated income taxes	206	747
Increase in expense	$ 223	$ 810

15. Transaction with certain parties:

The Company is obligated to an unconsolidated affiliated real estate company under 135 leases expiring through 1991. The minimum annual rentals applicable to such leases have been included in the lease obligations in Note 14. At July 30, 1977, advances to the affiliate of $3,262,000, including accrued interest have been included in accounts and notes receivable, not current.

The Company is obligated to Hasam Realty Corp., a major stockholder of the Company, under two store leases which expire in 1990. The leases provide for minimum annual rentals of $276,000, exclusive of taxes, insurance and other expenses.

16. Replacement cost information (unaudited):

To comply with the regulations of the Securities and Exchange Commission, the Company has estimated the replacement cost of its inventories and productive capacity at July 30, 1977 and the related impact on cost of sales and depreciation expense for the year then ended. Due to inflation, the cost to replace plant and equipment would be higher than the historical cost reflected in the financial statements, resulting in a higher depreciation charge. Such costs are not necessarily indicative of the current value of the related assets or management's intentions for replacement of such assets nor are they necessarily representative of costs that might be incurred in a future period. More detailed information regarding replacement cost will be found in the Company's Form 10-K Annual Report to the Securities and Exchange Commission.

17. Selected quarterly financial data (unaudited):

	Quarter ended			
	November 20, 1976	February 12, 1977	May 7, 1977	July 30, 1977
	(16 weeks)	(12 weeks)	(12 weeks)	(12 weeks)
	(in thousands, except per share amounts)			
Net sales	$734,991	$586,718	$528,387	$586,606
Gross profit	150,668	126,653	107,244	108,732
Income (loss) before cumulative effect of change in accounting methods	2,047	3,230	912	(2,943)
Net income	2,047	3,230	912	1,232
Earnings per share of common stock:				
Before cumulative effect of change in accounting methods	$ 28	$ 44	$ .12	($ .40)
Net income	$ 28	$ 44	$ .12	$ .16

The effect of the changes in accounting methods described in Note 2 on the individual quarters of 1977 is as follows:

	Quarter ended							
	November 20, 1976		February 12, 1977		May 7, 1977		July 30, 1977	
	Amount	Per share	Amount	Per share	Amount	Per share	Amount	Per share
	(in thousands, except per share amounts)							
Net income, as originally reported	$2,047	$.28	$3,230	$.44	$912	$.12	$1,232	$.16
Effect of changes in accounting methods, net of tax:								
Warehouse overhead	1,886	26	(224)	(.03)	145	.02	(1,807)	(.25)
Payroll taxes	1,095	.15	(67)	(.01)	(320)	(.04)	(708)	(.10)
Deferred income taxes	1,837	.25					(1,837)	(.25)
	4,818*	.66	(291)	(.04)	(175)	(.02)	(4,352)	(.60)
Net income, as restated	$6,865	$.94	$2,939	$.40	$737	$.10	($3,120)	($.44)

*Includes $4,175,000 ($.57 per share) for the cumulative effect of the changes in accounting methods described in Note 2

Report of Independent Certified Public Accountants

The Board of Directors and Shareholders
Food Fair, Inc.

We have examined the consolidated balance sheet of Food Fair, Inc. and Subsidiaries as at July 30, 1977 and July 31, 1976 and the related consolidated statements of income, shareholders' equity and changes in financial position for the fifty-two week periods then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As more fully discussed in Note 4, during 1977 the Company became involved in certain matters whose outcome is not susceptible to reasonable estimation. These matters consist of a legal action to recover workmen's compensation, automobile and general liability claims of $5,289,000 in excess of the deductible amount provided in the related insurance policies; the election of the Company to self-insure individual claims of $100,000 or less for the risks described above; and an action which alleges violations of certain sections of the Federal Securities Laws and common law principles.

As described in Note 4, the Federal income tax returns of the Company and certain subsidiaries have been examined by Internal Revenue Service for the fiscal years 1964 through 1968. The Service has proposed adjustments which would result in additional taxes of approximately $6,200,000 exclusive of interest. Since the material issues are being litigated, it is not presently possible to estimate the ultimate outcome of the tax controversies.

In our opinion, subject to the effects of such adjustments, if any, as might have been required had the outcome of the uncertainties referred to in the second and third above paragraphs, with respect to the 1977 financial statements, and the third above paragraph, with respect to the 1977 and 1976 financial statements, been known, the financial statements described above present fairly the consolidated financial position of Food Fair, Inc. and Subsidiaries at July 30, 1977 and July 31, 1976 and the consolidated results of their operations and changes in their financial position for the fifty-two week periods then ended, in conformity with generally accepted accounting principles applied on a consistent basis, other than for the changes, with which we concur, in the accounting methods described in Note 2 to the consolidated financial statements.

Philadelphia, Pa.
October 28, 1977 Laventhol & Horwath

STOCK PRICE DATA

The following table indicates the high and low sales prices of the Company's common stock on the New York Stock Exchange for the fiscal quarters indicated.

	FOURTH	THIRD	SECOND	FIRST
1977				
High	6 7/8	7 3/8	7 1/8	5 1/2
Low	5 1/2	6 3/8	4 5/8	4 1/2
1976				
High	6	6 1/2	5 1/2	5
Low	5 1/4	5	4	4

A cash dividend of 5¢ a share was paid in each of the calendar quarters.

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General Counsel Stein Rosen & Ohrenstein, 1370 Avenue of the Americas, New York, N.Y. 10019

Transfer Agent Registrar & Transfer Company, 34 Exchange Place, Jersey City, N.J. 07302

Registrar The Chase Manhattan Bank N.A., 1 Chase Manhattan Plaza, New York, N.Y 10015

Certified Public Accountants Laventhol & Horwath, 1845 Walnut Street, Philadelphia, Pa. 19103

DIRECTORS

Willard S. Boothby, Jr.	Chairman & Chief Executive Officer of Blyth Eastman Dillon & Co., Inc.
William P. Davis, III	Chairman of the Audit Committee Vice President for University Relations, Drexel University Chairman of the Executive Committee of First Pennsylvania Bank, N.A.
George Friedland	Retired Vice Chairman
Jack Friedland	President
Samuel Friedland	Chairman of the Executive Committee
Frank N. James	Vice President
Hess Kline	Chairman of George Allen, Inc.
Samuel P. Mandell	Investor
Gerald Nathanson	Vice President
Arthur S. Rosenberg	Retired Senior Vice President
Herman R. Silver	Retired Vice President
Louis Stein	Chairman of the Finance Committee Investor
W. Paul Stillman	Chairman of the Compensation Committee Chairman The First National State Bank of New Jersey The First National State Bancorporation, Newark, N.J. The Mutual Benefit Life Insurance Co.

CORPORATE OFFICERS

Jack Friedland	President Chief Executive Officer
J.A. Berger	Vice President Director of Manufacturing & Food Processing
Frank N. James	Vice President President, Pantry Pride Supermarket Division
J. Arvid Jonsson	Vice President Director of Industrial Relations
Gerald Nathanson	Vice President President, J.M. Fields, Inc.
S. Robert Silverman	Vice President Director of Distribution
Leo Dicandilo	Treasurer
Howard F. Gordon	Secretary
Franklin A. Gaber	Assistant Treasurer
Edmond O'Neill	Assistant Secretary
Harvey Richards	Assistant Secretary
Leonard Stubins	Assistant Secretary

DIVISIONAL OFFICERS

Pantry Pride Supermarket Division

President
- Frank N. James

Executive Vice President
- Marvin Lerner

Vice Presidents
- Herbert Carlis
- David Epstein
- Albert Faraldi
- Seymour I. Friedman
- Joseph Mazzochi
- Jack Miller
- Edwin Segal
- Jack Silverman
- Leonard Slider
- Sheldon B. Sosna
- Beryl Weinstein
- Herbert Zandler

Assistant Vice Presidents
- Robert U. Ochsenhirt
- Milton Seiger
- Ronald Stubin
- Robert Wein

Tulip Construction Division

Senior Vice President
- Marvin Kushner

Vice President
- Clyde Aul

Tulip Real Estate Division

Senior Vice President
- Sidney Tucker

Vice President
- Clarence J. MacManus

J.M. Fields, Inc.

President
- Gerald Nathanson

Senior Vice Presidents
- Elmer DiFilippo
- Robert Floum
- John Johnson
- Henry Kirschner
- Joseph Nusim
- Roy Reiner

Vice Presidents
- Elliot Belilos
- Robert L. Byrd
- Gerald Fitzgerald
- Robert Frady
- Jack Rule
- Howard Siegrist
- James Van Gundy

Manufacturing

Vice Presidents
- Edward Paskow
- Martin Rosenthal

Meat Processing

Vice President
- Edward Laken

Ideal Shoe Company

President
- Leonard Pasternak

Senior Vice President
- Alexander Aezen

Vice Presidents
- Harry Haber
- James T. O'Sullivan

Washington Square Life Insurance Company

President
- Jay Gross

Vice President
- Jerome Brandt

Treasurer
- Ronald Funk

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